Report of Joint Study Group on OMERS Investment Policies

Ontario Municipal Employees Retirement System

Ontario, Ontario Municipal Employees Retirement System.

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February 14, 1974

OMERS Joint Study Group

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Foreword

The Honourable John White, the Treasurer of Ontario and the Ontario Municipal Employees Retirement Board established the OMERS Joint Study Group to study OMERS' present investment policies, alternatives thereto and related matters and to report thereon.

OMERS provides pension benefits for Ontario's municipalities, their local boards and certain of Ontario's post-secondary educational institutions. OMERS has been growing very rapidly and has become one of Canada's largest and most complex pension funds (with an annual income of $125 million; investments of $503 million) and provides a full range of pension benefits to 93,000 men and women in every section of Ontario.

The funds of OMERS (on the recommendation of the persons who recommended the establishment of OMERS) have been invested, exclusively, in non-marketable Province of Ontario debentures since the establishment of the System in 1963. The desirability of OMERS' investment in these debentures has been a matter of discussion, for some years, between the Board of OMERS and the Ministers responsible for The OMERS Act. The investment is being questioned by associations of the municipalities and school boards, by associations of municipal and school board officers and employees, by members of the Legislature and others.

The Study Group's terms of reference—which were approved by the Board of OMERS on November 16th and by the Treasurer on November 26th—are to be found on Table No. 1 of this Report.

The Study Group consulted with associations of the municipalities, the school boards, their officers and their employees with regard to the investment of OMERS' funds and, in addition, held discussions with investment dealers; managers of the investments of a number of major pension funds, including the funds of the larger Ontario municipalities. The advice and assistance of certain experts in the management of pension fund monies was secured.

The Group regrets that, because of the Christmas and the New Year seasons and because of the date established, originally, for the completion of its report (January 15, 1974), the time available for consultation with associations was not as long as the Group would have wished. However, opinions of associations, which are quoted, extensively, in Chapter No. 9, were received and were studied.

The Report commences with a statement of the Study Group's recommendations and findings.

The growth of OMERS and a review of the investments of OMERS, past and future, is presented.

The investment policies and practices of pension funds in the private and in the public sectors in Canada, the United States and Great Britain are summarized. The returns which could be available to OMERS from the investment of the savings of its employers and members in Canadian marketable securities are analyzed, thoroughly—as is the significance to OMERS of increased returns, i.e. increased pension benefits or decreased contributions.

Comments are made with regard to OMERS' relationship with the Canadian capital markets. Alternative investment policies for OMERS are presented and discussed, at length.

The opinions of Ontario's municipalities, school boards, members of OMERS and others, concerning OMERS' investment policies are summarized. Issues which could arise from a continuation of OMERS' present investment policy are discussed.

The significance to OMERS of organization and of personnel to the success of an investment program in marketable securities is emphasized.

The Study Group express its sincere appreciation to those who contributed their opinions, their experiences and their advice to the Group's understanding of the issues, the principles and the practices which are associated with an appraisal of OMERS' investment policies.

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1 Recommendations and Findings of the Study Group

The Study Group was asked under its Terms of Reference, primarily, to "study and report" with regard to "alternative investment programs and an appraisal thereof". While carrying out this task, the Study Group examined and appraised alternative investment programs to see if they were in "OMERS' best interests"—i.e. an investment program which would produce the highest rate of return, consistent with the safety and the purchasing power of the System's investments.

1
While, perhaps, beyond the Group's Terms of Reference, a number of questions arose during the Group's studies relating to certain aspects of the Province of Ontario's position with regard to OMERS which are of concern to the employers and the members of OMERS and others. These aspects should be reviewed. They are as follows:

(a) Should the personal savings deposited into the OMERS fund, by or on behalf of the members, be channelled into the Province of Ontario's consolidated revenue fund (and thereby reduce Ontario's demand on the Canadian capital markets) or be channelled, directly, into the Canadian capital markets and into the economic activities supported by the capital markets? (The policies of Canada's 10 provinces and their municipalities, with regard to the investment of the pension fund savings of their civil servants and of their civic servants, are reviewed in Chapter 4.)

(b) The Province's role, as the custodian of the savings of OMERS (through The OMERS Act and Regulations and the Province's power to appoint the members of the Board of OMERS) is of concern to the employers and the members of OMERS and others. The concern is whether an alternative investment policy would produce a greater rate of return, consistent with the safety and the purchasing power of the investments. (These matters are discussed in Chapter 10.)

(c) Should the Province deny to OMERS the opportunity to maximize the rate of return on the System's investments, indefinitely? Should the Province's borrowing needs or money costs be a factor in the determination of OMERS' investment policies? (These matters are discussed in Chapters 5 and 8.)

2
OMERS' funds are invested in non-marketable debentures because the Government of Ontario, in 1962, accepted a recommendation that special, long-term, non-marketable Ontario debentures be issued in order to establish a retirement system for Ontario's municipalities and local boards—at uniform, stable and reasonable rates of contributions—regardless of the age or the sex of the employee and regardless of the size or the location of the local government, board or institution—and, thereby, dispose of one of the Government's most pressing and, increasingly complicated, municipal finance problems.

If Ontario had not agreed to issue such debentures to OMERS, OMERS may never have been established, and the benefits of OMERS may never have been available to the Ontario local governments, their local boards and their thousands of employees. (see Chapters 2 and 10)

3
If OMERS' future contributions were to be invested in a full range of marketable securities under The Pension Benefits Act and the Regulations thereunder, rather than in non-marketable Ontario debentures, the Study Group's studies support the finding that OMERS could achieve a higher return on the System's funds—possibly, from a minimum of, say, ¾ of 1 per cent per annum to a maximum of, say, 1¼ per cent per annum. (Such a higher return, on the basis of the funds to be available for investment would increase the System's investment income, considerably.)

The Study Group cautions, most emphatically, however, that an increased rate of return would not be automatic (much work and knowledge would be required, over a relatively long period of time, by OMERS' policy makers and investment managers) and the effect of a greater rate of return would not be immediate (OMERS' present investment in Ontario debentures is large, and, therefore, the impact of securities with higher returns would not be reflected in OMERS' total rate of return for some years). (see Chapters 3 and 5)

4
Primarily, as a result of inflationary forces, members of OMERS are searching for ways to convert OMERS' basic pension benefits from a career earnings formula to an earnings at or near retirement formula—such a benefit would require an additional contribution of 3 per cent of earnings. In addition, as the result of these same inflationary forces the Board of OMERS is searching for ways to protect the purchasing power of OMERS' pensions after the retirement of the members—such a benefit would require an additional contribution of 8 to 9 per cent of earnings, if recent rates of salary and wage increases continue.

If OMERS is to provide any or all of these increased benefits, the System will require substantial increases in income, which can be derived from a combination of:

(a) the taxes and other income of the municipalities, local boards or local institutions,

(b) the earnings of OMERS' members and

(c) the System's investment income. (see Chapter 6)

5
Every investment specialist whom the Study Group consulted was of the opinion that the best interests of the employers and of the members of OMERS would be served if

OMERS' monies were to be invested in marketable securities of the Canadian capital market. (see Chapter 9)

6
Every municipal association and municipal officer whose correspondence the Study Group examined, or with whom the Group corresponded or held discussions, expressed the opinion, in one way or another, that The OMERS Act be amended to permit the savings of the members to be invested in accordance with "more diversified investment policies—to obtain the highest possible return". (see Chapter 9)

7
OMERS should not be authorized to invest in marketable securities unless the Treasurer of Ontario and the Government of Ontario are of the opinion that a high standard of organization and of personnel can be achieved, i.e. OMERS' organization should be sound, its policy makers should be persons of integrity, experience and maturity; its policies should reflect common sense and its investment managers should be thoroughly trained, be experienced and possess courage and investment insight. (see Chapter 11)

8
The cost to OMERS of a first-class investment management organization, within a relatively few years, would represent a small fraction of the additional income which OMERS would receive if the System were to be authorized to invest in a portfolio of marketable securities—approximately .15% of investment income. (see Chapter 11)

9
The amount of OMERS' funds to be available for investment each year during the next 15 years, commences at $120 million in 1974; rises to $213 million in 1979; to $311 million in 1984 and to $411 million in 1988. (see Chapter 3)

10
On the assumption that OMERS' funds would be allocated to every section of the Canadian capital market, it is reasonable to assume that the investment of OMERS' funds in the capital market, insofar as size is concerned, would not give rise to a significant effect on the market. (see Chapter 7)

11
There are well-founded reasons for OMERS to invest a reasonable portion of its funds in marketable securities of Ontario and of its municipalities, subject to market conditions. Such investments by OMERS would improve the tone of the market for the Ontario municipal debenture; contribute to the establishment of a secondary municipal market; and tend to stabilize the cost of long-term money to the municipalities. (see Chapter 8)

12
In the System's best interests, OMERS should not commence to invest all monies in marketable securities as of a specified date. The task of doing so would be enormous and should, therefore, be spread over a period of, say, five years. In the interim, monies not invested in such securities could be invested in Ontario debentures. (see Chapter 11)

2 Growth of OMERS, Past and Future

OMERS was established, as of January 1, 1963, to meet one of the urgent needs of Ontario's local governments, local boards and other local institutions, namely, the need to obtain adequate pension benefits for the thousands of employees of these governments, boards and institutions—at uniform, stable and reasonable rates of contribution—regardless of the age or the sex of the employee and regardless of the size or the location of the government, board or institution!

OMERS has attempted to fill this urgent need. OMERS has been welcomed and has been accepted by the municipalities, their local boards and other local institutions!

The System, as a result, has grown very rapidly and has become one of Canada's largest pension organizations.

OMERS' growth, past and future, is presented on Table No. 2. The highlights of the Table are as follows:

Year	Contributors	Pensioners	Contributions	Interest Earned	Pension Benefits and Administrative Expenditures	Investments
				in millions of dollars		
Actual						
'63	9,840	19	$ 4			$ 4
65	24,018	392	14	$ 1	$ 1	29
67	48,449	1,224	24	3	2	74
69	64,084	2,502	44	7	4	154
71	80,553	4,565	65	16	6	287
73	92,721	7,028	98	39	12	503
Estimated						
78			145	90	47	1,268
83			227	183	120	2,524
88			350	316	255	4,314

3 Investments of OMERS, Past and Future

Original Investment Policy

OMERS' original investment policy was developed, specifically, to meet OMERS' original investment need, namely, a need to secure an unusually long-term security because of:

(a) factors associated with the existence, in the early 60's, of hundreds of "approved pension plans" in the Ontario municipalities which were underwritten by life insurance companies and trust companies,

(b) actuarial principles and actuarial constraints, and

(c) a need for stability in the rates of contribution to OMERS.

After studies and discussions in 1962 between members of the Government (Messrs. Cass, Allan and Robarts) and their advisers, the Government decided to recommend to the Legislature (a) the establishment of OMERS and (b) a commitment by Ontario to issue to OMERS, each year, during a 10-year period, a non-marketable 5% debenture, with interest payable half-yearly and, at the end of the 10-year period, to exchange the ten debentures issued during the 10-year period for a single 5% 40-year debenture.

The 5% was within a few basis points of the cost of long term money to Ontario at the time of the Government's decision to establish OMERS—late in 1962.

A debenture with such a long term could not have been purchased in the Canadian security markets.

Investment Policy Changes of '68 and '70

Within a short time of the establishment of OMERS, rates of interest in Canada, after many years of stability, began the long, continuous climb of the 60's and the early 70's.

To secure the benefit of the increasing rates of interest for OMERS, as an investor, the rate of interest on the Ontario debentures was changed

(a) effective with the year 1968, to a rate of 6½% per annum, while

(b) effective with the year 1970, the rate was floated at a rate not less than the weighted average yield to maturity of the debentures and bonds issued or guaranteed in Canadian dollars by the Province within each year, plus ⅛ of 1% (to recognize that the availability of OMERS' funds to Ontario would eliminate Ontario's need to

borrow such sums in the capital markets and to incur the legal, printing, bookkeeping, registration, bank and other charges which result from such a borrowing) for a term of not less than 20 years and not more than 30 years.

Investment Policy Change of '73

In early 1973, because of the continuous climb in rates of interest and, undoubtedly, because of inflationary conditions, generally, certain members of OMERS became concerned with the provision of The OMERS Act under which the 5% Ontario debentures issued for the years '63 to '67 and the 6½% debentures issued for the years '68 to '69 would be exchanged for debentures of an equal amount—at the same rates of interest—to be due and payable in the year 2013.

Subsequently, associations of municipal and school board officers and employees and of municipalities and school boards expressed their concerns to the OMERS Board, to Mr. John White, the Treasurer of Ontario, and to members of the Legislature.

Mr. White requested his advisers to prepare a study of the problem. He discussed the problem with the Board of OMERS, the Municipal Liaison Committee (Association of Municipalities of Ontario, Association of Counties and Regions of Ontario, Ontario Association of Rural Municipalities) and others.

On the basis of the study and the discussions—because of the historic increases in the rates of interest during the 60's and the early 70's and because of his wish that the position of Ontario's local governments be enhanced—Mr. White decided to recommend to the Government that the applicable provisions of The OMERS Act be amended.

Mr. White's amendment was based on the following principles, (a) the Ontario debentures to be exchanged as of December 31, 1973 (for the debentures issued for the years '63 to '67 and for the years '68 to '69) should bear rates of interest which reflect the weighted average yield on the monies which Ontario borrowed in the public market in each of these years (essentially, the principle introduced into The OMERS Act, effective with the year 1970, should be made applicable to each year since the establishment of OMERS); (b) the term of the debentures should be shortened; and (c) a special payment, of the differences between the original rates of interest on the debentures issued for the years 1963 to 1969 and the rates of interest authorized by the amendment, should be made by Ontario to OMERS.

Mr. White's amendment was accepted by the Government and enacted by the Legislature at its last session.

The following schedule illustrates the effect of Mr. White's amendment:

Ontario non-marketable debentures

Year	Amount	Rates of Interest[1] Original	Rates of Interest[1] as Amended	Terms in Years Original	Terms in Years as Amended	Amount of Annual Interest Original	Amount of Annual Interest as Amended
'63	$ 4,400,000	5 %	5.49%	50	30	$ 220,000	$ 241,560
64	10,700,000	5	5.56	49	30	535,000	594,920
65	14,100,000	5	5.54	48	30	705,000	781,140
66	20,100,000	5	6.00	47	30	1,005,000	1,206,000
67	24,900,000	5	6.30	46	30	1,245,000	1,568,700
	74,200,000					3,710,000	4,392,320
68	33,100,000	6½	7.21	45	30	2,151,500	2,386,510
69	46,700,000	6½	8.19	44	30	3,035,500	3,824,730
	79,800,000					5,187,000	6,211,240
	154,000,000					8,897,000	10,603,560
70	57,600,000	9.1		30			
71	75,000,000	7.85		30			
72	91,300,000	8.02		30			
Weighted average rate of interest						5.78%	6.89%

[1]Payable half-yearly

As the result of the amendment, for the years 1963 to 1969, the weighted average rate of interest on the Ontario debentures was increased from 5.78% to 6.89%; the average term of the debentures was reduced by 17 years; while the total amount of the annual interest on the debentures was increased from $8,897,000 to $10,603,560—an increase of $1,706,560 or 19%.

The special payment to OMERS was in the amount of $9,045,170—the amount of the payment was the difference between the amounts of interest which would have been received by OMERS—if the amended rates had applied from the date of issue of each of the debentures—less the amounts of interest actually received—at simple interest.

Ontario debentures served OMERS well

Before leaving the topic of OMERS' investments for the years 1963 to 1973, the Study Group wishes to state that the Ontario debenture has served the interests of OMERS very well, indeed!

In fairness to those responsible for the development of OMERS' investment program in 1961 and in 1962 (the responsible Minister was F. M. Cass, the Premier was John P. Robarts, the Treasurer was James N. Allan and the Deputy Minister of Municipal Affairs was the late Dr. L. R. Cumming) and, for the information of those who have been questioning OMERS' investment program, it is essential to emphasize that OMERS' present investment program has evolved from OMERS' initial investment program and that, *if Ontario had not agreed to the establishment of OMERS' initial investment program, OMERS may never have been established, and the benefits of OMERS may never have been available to the Ontario local governments, their local boards and their thousands of employees.*

OMERS' Funds available for Investment

The Study Group's terms of reference requires the Group to study and to report with regard to *"the amount of OMERS' funds—basic, prior service, supplementary benefits and administered pension funds—which will be available for investment for each of the next 15 years".*

The amounts to be available for investment have been estimated by The Wyatt Company, OMERS' actuaries. The details are presented on Table No. 3.

The total amounts are as follows:

in millions of dollars

'74	$120	'79	$213	'84	$311
75	137	80	231	85	333
76	153	81	251	86	355
77	167	82	271	87	380
78	188	83	290	88	411

4 Investment of Pension Funds

Introduction

The Chapter commences with comments on the statutes which regulate the investment of Canadian pension funds and by classifying the investments in which pension funds of the private sector in Canada, the United States and Great Britain are invested. Information on the relative rates of return on the classes of investments in these jurisdictions, including Canada, is difficult to obtain and is not provided in the Chapter.

The Chapter proceeds to discuss funding methods and investment practices of Canada, the provinces and their municipalities—with particular reference to Ontario, to its municipalities and to the Quebec Deposit and Investment Fund.

The Chapter concludes by describing the organization for, and the investment of, state and local government pension funds in the United States.

Investment of Pension Funds in the Private Sector: Canada

The investment of private pension funds in Canada, generally, is controlled by a series of statutes which were enacted in Canada as the result of the publication in the early 60's of the reports of The Ontario Committee on Portable Pensions.

As a result of the work of the Committee, Ontario enacted The Pension Benefits Act (*"to provide for the improvement of pension plans throughout Ontario"* and to impose standards with regard to vesting, funding, solvency, investment, etc.); Canada enacted The Pension Benefits Standards Act; and Quebec, Saskatchewan and Alberta, for instance, enacted similar statutes.

Insofar as the investment of pension funds is concerned, the Regulations under the Ontario statute (which include many of the investment authorizations and investment restrictions of The Canadian and British Insurance Companies Act—a very old statute which has been used to regulate the investment practices of financial institutions in Canada for many years) were approved in order to provide safeguards against a lack of diversification in investments, excessive investment in the securities of a single corporation or entity and investment in speculative securities. The Regulations are lengthy and demand a thorough knowledge of, and experience with, a wide range of Canadian securities.

The classes of investments which are authorized under the Regulations include bonds and debentures of Canada, provinces, municipalities and corporations, and mortgages and stocks. Investments which demand the services of highly skilled managers,

such as participation in, or equity in, major real estate developments or other enterprises, are also authorized.

Statistics Canada does not publish a separate statement of pension funds in the private sector in Canada—its statements includes pension funds in Canada with invested assets, including those for federal and provincial crown corporations, the provincial civil servants, the municipal civic servants, etc.

Statistics Canada's statement is summarized for three selected years on Table No. 4.

The Table discloses that the pension funds of Canada were invested as follows at December 31, 1971: obligations of Canada 3%; obligations of provinces 27%; obligations of the municipalities and school boards 6%; corporate bonds 16%; mortgages 9%; common stocks 25%; other assets 14%.

The distribution of investments which is disclosed on Table No. 4 is not typical of the average Canadian pension fund because provinces and municipalities may invest all, or a large portion, of the savings of major pension funds in their own debentures or bonds.

It is to be noted that, in recent years, the percentage of funds allocated, according to Statistics Canada's statement, to obligations of governments has been reduced, sharply, while the percentage of funds allocated to common stocks and "other" investments has been increased, correspondingly.

The Study Group is informed that many pension funds in the Canadian private sector are invested, at the present time, as follows: bonds 25%; mortgages 25%; stocks 50%. The actual percentages for a particular fund will vary with the fund's investment philosophy and with its current investment strategy.

Investment of Pension Funds in the Private Sector: United States

A statement of private pension funds in the United States is published by the United States Securities and Exchange Commission.

The Commission's statement for 3 selected years is summarized on Table No. 5.

The Table discloses that the pension funds of the private sector in the United States were invested as follows at December 31, 1971: obligations of the United States 2%; corporate and other bonds (includes state and local government obligations) 27%; mortgages 4%; common stocks 59% and other assets 8%.

It is to be noted that, in recent years, the major portion of the new monies which flow

into these funds has been invested in common stocks (as a percentage of total monies invested, common stocks increased from 37% in 1962 to 59% in 1971).

Investment of Pension Funds in the Private Sector: Great Britain

A statement with regard to the investment of pension funds in the private sector in Great Britain is on Table No. 6.

The statement indicates that a substantial portion of these pension funds are invested in the "ordinary" shares of companies—as a matter of fact, in 1971, 58% of these funds were invested in ordinary shares and, further, of the net new investments made during that year, 46% was invested in ordinary shares.

Investment of Pension Funds in the Public Sector: Federal, the Provinces, the Municipalities

Time did not permit the collection of all of the relevant information with regard to the investment of federal, provincial and municipal pension funds; however, the information collected was reasonably complete.

Federal pension plans, such as the Public Service Superannuation Plan and the RCMP Superannuation Plan, are funded. Civil servants' contributions; Canada's matching contributions; interest on contributions; and actuarial adjustments are credited to an account. The credit balance of the account is carried as a liability of Canada's consolidated revenue fund. The funds to the credit of the account are not invested in marketable securities, but, are made available to Canada for its capital purposes.

However, the pension plans of many federal crown corporations, boards and commissions are invested in marketable securities—as a matter of fact, some of these funds are among the most progressively-managed (from an investment point-of-view) in Canada, i.e. Canadian National Railways, Air Canada, Central Mortgage and Housing Corporation, Bank of Canada, Canadian Broadcasting Corporation, etc.—the investments are well in excess of one billion dollars.

Provincial pension plans fall into 3 categories—(a) not funded; (b) partially funded; and (c) funded.

Pension plans, not funded
Newfoundland public service; Newfoundland teachers; New Brunswick teachers; Quebec public service; Quebec teachers; Saskatchewan public service; Alberta public service; Alberta local authorities

Pension plans, partially-funded
New Brunswick civil service; Manitoba teachers; Alberta teachers

Pension plans, funded
29 other pension plans

In the case of a pension plan, not funded, the contributions to the plan of the civil servants are credited, directly, to the province's consolidated revenue fund as a revenue.

The Group understands that the Province of Quebec decided, recently, to commence to fund the contributions of the civil servants and to invest the monies in marketable securities and the Province of Saskatchewan's policy is under review.

What reasons are put forward for not funding the liabilities of a government pension fund? Some are as follows:

(a) A government does not default on its commitments. A government's pension commitments will be paid according to the terms of its pension plan. Therefore, a government's employees need not be concerned that the government's pension liabilities are not funded and that employee contributions are being credited to revenues.

(b) A government is not required to impose taxes to provide for the employer's contribution as required under the terms of conventional pension plans—the imposition of the required taxes is deferred; in addition, a government has the use of employees' contributions as a revenue.

(c) If a government does not establish a fund, the need to manage an investment portfolio does not arise.

What reasons are put forward for funding the liabilities of a government pension fund? Some reasons are as follow:

(a) A government's pension liabilities should be recognized, accepted and provided for as they arise. The cost of one generation's pensions should not be imposed on a future generation.

(b) The obligation to raise taxes in future years, for pension commitments of earlier years, should not be permitted to occur.

(c) If the costs of pensions are not funded, governments, their employees and taxpayers, may not realize the significance of the ultimate cost of pensions—the benefits to be derived from pensions may not be related, accurately, to the costs of pensions.

(d) Income from the investment of the contributions of a government and its employees to pensions is available to either reduce the costs of pensions or to improve pensions.

(e) Savings generated by a funded pension plan contribute to the well-being of the capital markets and to the growth of the economy.

There has been some indication of concern among employee associations of other provinces with the non-funding of their pension plans; with the non-investment of their pension contributions; and with the relationships between non-funding, non-investment and the level of pension benefits.

In the case of the pension plans, partially-funded, the contributions of the civil servants to the plan, are withheld from the revenues of the province and are credited to a special account or provision.

Of the 29 provincial pension plans which are funded, 9 do not invest in marketable securities of the public capital markets but, rather, invest in non-marketable debentures of the province concerned.

The nine plans are as follows:

Ontario

Public service; the teachers; OMERS

British Columbia

Public service; teachers; municipal employees; B.C. Hydro; legislative assembly; workmen's compensation.

Ontario's pension plan for its civil servants is funded. Civil servants' contributions; Ontario's matching contributions; interest on contributions; and actuarial adjustments are credited to an account. The credit balance of the account is carried as a liability of Ontario's consolidated revenue fund. The funds to the credit of the account are not invested in marketable securities, but, are made available to the Province for its capital purposes.

Ontario's pension plan for teachers is funded. A fund, separate from Ontario's consolidated revenue fund, is maintained. The contributions, interest and actuarial adjustments are determined in a manner similar to those for the civil servants. The monies to the credit of the fund are invested in non-marketable Ontario debentures and are made available to the Province for its capital purposes.

Insofar as British Columbia is concerned, the monies of the pension funds listed above have been invested in securities of either the Province or of one of the crown cor-

porations, such as B.C. Hydro—at rates of interest which were less than market.

A policy decision was taken, recently, that these pension funds no longer be called upon to "subsidize" the operations of the Province or of its crown corporations. Rates of interest on securities in which the funds are to be invested must, in future, be equal to rates of interest which the Province or a crown corporation would be required to pay in the public market. In addition, amendments have been made which authorize the funds to be invested in the common stock of corporations.

The practise of investing the pension savings of civil servants in non-marketable securities of Canada, or of a province or of a crown corporation is of concern to some students of the workings of the Canadian economy. Such a concern is, of course, a matter of opinion.

For instance, John R. Ferguson, a well-known Canadian investment counsel, in an address to the Montreal Economic Association made the following comments on this topic, *"If the personal savings (of civil servants) paid into pension plans—were funded —(in marketable securities) there would be considerably more funds flowing through to the financial markets and an increased availability of funds for the needs of Canadian individuals." "It should be important in a free enterprise economy that personal savings—be employed in the financial markets so that persons will have access to them for the financing of their economic activities. The alternative is for the personal savings to become government funds and to be allocated as government funds." "It is very important to the health of the economy that financial markets should function efficiently. They cannot function efficiently, however, when governments interfere with the flow of savings and direct them away from the financial markets."*

Of the remaining 20 provincial pension plans which are funded and are invested in marketable securities, it must be stated that very large amounts of their funds have been allocated to the support of the market for the debentures and bonds of the province concerned.

Municipal pension plans in Canada, with the exception of British Columbia's, Alberta's and Ontario's province-wide plans for municipal employees, would appear to be funded individually and be invested in marketable securities—frequently, a large portion of these funds are invested in municipal debentures.

Investment of Ontario's Provincial Pension Funds

The funds of the Public Service Superannuation Fund (PSSF), the Teachers' Superannuation Fund (TSF) and OMERS are either loaned directly to the Province or are invested in non-marketable debentures of the Province.

(The Regulations under The Pension Benefits Act do not limit the amounts which may be invested in the bonds and debentures of a single government and, as a result, the investment of the funds of the PSSF, the TSF and OMERS in non-marketable Ontario debentures is in accordance with Regulations under the Act.)

The pension funds of the Hydro Electric Power Commission (HEPC), the Workmen's Compensation Board (WCB) and 15 or more other agencies of Ontario are invested in marketable securities purchased in the public capital markets.

The funds of the Hospitals of Ontario Pension Fund are invested in the public capital markets.

The PSSF and the TSF—each of which is a very old fund—were established to provide pensions for Ontario's civil servants and the teachers of Ontario's local school boards. Both funds were permitted to accumulate very large actuarial deficits prior to the enactment of The Pension Benefits Act. Ontario, and not the local school boards who are the employers of the teachers, contributes the employers' contributions to the TSF.

In the case of the PSSF and the TSF, the costs of pensions in excess of the employees' contributions are provided from the revenues of the Province of Ontario; whereas, in the case of OMERS, such costs are provided from the revenues of the municipalities.

The Hospitals of Ontario Pension Fund is quite similar to OMERS—a multi-employer fund; Ontario-wide; many of the public hospitals are a local board of a municipality.

Insofar as Ontario's pension funds are concerned, the question to be asked is, "If the pension funds of the HEPC, the WCB and 15 or more other agencies of Ontario and the public hospitals of Ontario are authorized to invest in marketable securities, why is OMERS not authorized to invest in marketable securities?" Since the return on market-oriented securities is greater than the return on the non-marketable debentures in which OMERS' funds are invested (see Tables No. 9 and No. 10) and, since the difference in the returns must be provided from the revenues of the municipalities, the answer to this question is extremely significant to the employers and to the members of OMERS.

Investment of Quebec's Deposit and Investment Fund

The Study Group is of the opinion that a brief reference to the investment policies of the Quebec Deposit and Investment Fund is appropriate.

The Fund manages the savings which are accumulated by the employers and the members of the Quebec Pension Plan.

According to the Annual Report of the Fund for the year ended December 31, 1972, the Fund ($2,113,376,040) was invested as follows: 64% in the public sector (3% Canadas; 55% Quebecs; 6% municipal and school) and 36% in the private sector (11% corporate bonds; 3% mortgages; 17% stocks; 5% in real estate and other investments).

The monies of the Fund are invested, substantially, in marketable securities purchased in the public capital markets.

According to a recent study by Professors Shaw and Archibald of the School of Business Administration at the University of Western Ontario, the investment priorities of the Fund are to: (a) protect the safety of the monies deposited; (b) give preference to investments of economic benefit to the Province of Quebec—if the estimated rates of return and the risks are equal; and (c) act as a market for the debentures and bonds of the Province and of Hydro Quebec (and of the Province's municipalities and school boards).

A few quotations from the Fund's 1974 Report are significant. *"The Fund allocated a substantial part of its resources to the purchase of Government of Quebec and Hydro Quebec bonds." "Purchases of some $14.8 million of (municipal and school debentures) were made during the year."*

According to Professors Shaw and Archibald, the Fund manages the monies deposited *"actively and aggressively";* has achieved a superior investment performance; and has earned, for instance, *"a weighted average of the annual rates of return on its stock portfolio of 14.2% for the year 1967, when stocks were first acquired, to the end of 1972".*

Investment of Ontario's remaining individual Municipal Pension Funds

A few of Ontario's largest municipalities maintain one or more trusteed pension funds for certain of their employees—the funds were established before OMERS was organized. The funds provide pension benefits for persons who were employees of the municipalities prior to the enactment of The OMERS Act.

With the exception of the City of Hamilton's Fund, (the Fund was authorized to invest under the terms of The Canadian and British Insurance Companies Act [Canada] in 1957, i.e. corporate bonds, mortgages, stocks, purchase leasebacks) these large funds have been invested, until recent years, exclusively, in bonds and debentures.

However, during the last few years, their investment policies have been broadened to include corporate bonds, mortgages and common stocks.

The investments of six of these municipal pension funds are classified on Tables No. 7-1 and No. 7-2.

Investment of Pension Funds of State and Local Governments in the United States

In the United States the great majority of the employees of local governments are members of a retirement system which provides pension benefits for the employees of the state and, also, for the employees of its local governments; a lesser number of such employees are members of a state-wide retirement system for local government employees, only,(OMERS was patterned after such systems); while a much lesser number are members of a pension plan for the employees of a single local government.

According to information furnished by the Municipal Finance Officers Association of the United States and Canada, the power of these state and local pension funds to make investments is vested in: (a) a board of trustees —in 37 of the states; (b) an investment board which invests, not only pension fund monies, but other monies of the state— in 6 of the states; and (c) a variety of other related methods—in the other 7 states.

In the case of the 37 states with a board of trustees, investments are made under a number of arrangements, depending upon the size of the system. In the case of smaller systems, the board of trustees usually makes investment decisions in cooperation with the officers - sometimes with the advice of an investment counsel. In larger systems, the board of trustees may establish general investment policies (frequently, with the assistance of an investment counsel) and may delegate the execution of its policies to its officers; or the board may grant the power to invest to an investment committee—in some cases, the investment committee may include members of the board, while in other cases it may not.

The monies of these pension funds are invested, in accordance with broad statutory authorizations and restrictions, in marketable securities purchased in the capital markets. 88 per cent of the monies are invested in the private sector.

One of the most notable features of an analysis of the investment of the pension funds of the state and local governments in the United States is the small percentage of the funds which is invested in the securities of governments. Table No. 8 discloses that, at December 31, 1971, while the total of these funds was $65 billion, only $8 billion, or 12%, was invested in the securities of governments. Of the $8 billion, the largest portion was invested in securities of the state and local governments—interest on such securities is non-taxable.

In a report entitled "Economic Aspects of Pensions" published, in 1968, by the National Bureau of Economic Research, the following statement is made with regard to the investment of the funds of state and local government retirement systems: *"in the*

last fifteen years (these Systems) have ceased to be captive markets for (marketable) government securities. They have entered the private capital markets on a large scale —notably the corporate bond market, more recently the mortgage market—and the market for corporate common stocks on a modest scale. They have increasingly sought professional investment advisory services and become conscious of rate of return and of investment management performance".

5 Returns to OMERS on Marketable Securities

Introduction

This Chapter contains a hypothetical comparison between relative returns on OMERS' non-marketable Ontario debentures and on marketable securities in the Canadian capital markets.

Rates of return which have been achieved on the investments of Canadian pension funds is discussed.

The Chapter concludes with a statement of the greater return which OMERS might expect to secure if the System's funds were to be invested in a conventional portfolio of marketable securities, rather than in non-marketable Ontario debentures—and with the emphatic caution that a greater return would not be automatic nor would the effect of such a return be immediate.

Non-marketable Ontario debentures vs marketable securities

One of the Study Group's most important terms of reference was to report on the "rates of return" to be achieved under "alternative investment programs". Much time was allocated to this topic—to the relative returns on OMERS' non-marketable Ontario debentures and on marketable investments in the Canadian capital markets. The Study Group secured information from, and held discussions with, investment dealers, investment counsel, managers of pension funds and others. The preparation of, and the analysis of, relative returns on securities has been time-consuming and elusive. However, with the assistance and guidance of McLeod, Young, Weir & Company Limited, the Study Group is satisfied that a reliable and a useful standard of relative performance has been prepared.

A standard is presented on Tables No. 9, No. 10 and No. 11. Every effort has been made to ensure that the Tables, including the notes, are accurate and complete.

Table No. 9 illustrates, for each of the years 1963 to 1972, (coincides with OMERS' first 10 years) the returns on OMERS' non-marketable Ontario debentures and the yields actually prevailing in the market for provincial, municipal and corporate bonds and debentures and mortgages; and the return on common stocks. Table No. 10 illustrates relative yields and returns on these same securities for the same 10-year period—on three quite different bases. This table indicates that the average annual yield to maturity on the debt securities (based on the "re-investment option") and the rate of return on common stocks (based on market values) of the following classes of securities, for the 10-year period ended in 1972, were as follows:

Non-marketable Ontario debentures	7.07%
Provincial bonds	7.22
Municipal debentures	7.46
Corporate bonds	7.41
Mortgages	8.38
Common stocks	9.53

Table No. 10 also indicates that during this same period, on the basis of market values, the average rate of return on common stocks was much greater than the average return on provincial bonds, municipal debentures or corporate bonds (9.53% vs 4.63%; 4.79% and 4.48%)—primarily because of capital losses on the debt securities (during a period of rising interest rates) and capital profits on the common stocks.

Table No. 11 presents a hypothetical return from the investment of OMERS' funds in marketable securities as compared to OMERS' return from the non-marketable Ontario debentures. The data presented in Table No. 11 are based on the assumptions in the two preceding schedules (returns based on the McLeod, Young, Weir 40-bond index, the Bank of Canada's monthly index of mortgages and the Toronto Stock Exchange's industrial index; the re-investment option; and the investment weightings on Table No. 11—the weighting, which allocates 35% of the portfolio to provincial bonds and municipal debentures, is quite conservative and tends to favour investment in these two classes of securities).

Table No. 11 indicates that the return from the investment of funds in marketable securities compares favourably with the return from the non-marketable Ontario debentures, during the 10-year period ended in 1972, on the basis of the assumptions made in Tables No. 9, No. 10 and No. 11.

Gross return on the hypothetical portfolio (approximate)	8.15%
Deduct: Expenditures to manage the portfolio	.15
Net return on the hypothetical portfolio	8.00
Deduct: Gross return to OMERS on non-marketable Ontario debentures	7.07
Difference between: Gross return to OMERS on non-marketable Ontario debentures and Net return on the hypothetical portfolio	.93%

It will be noted that the net return on the hypothetical portfolio exceeded the gross return to OMERS on non-marketable Ontario debentures by some 90 basis points over the period—on the assumptions made in this section.

Care should be taken in interpreting these data. Tables No. 9, No. 10 and No. 11 do not, of course, disclose the returns which OMERS could, actually, have obtained during this period if the System had invested in such marketable securities—because, for instance, regardless of the yields in the market, at any time, the investor does not receive interest on the basis of yields in the market—i.e. if rates of interest rise, the actual return received on fixed income securities is less than the yields in the market; while the reverse applies, if rates of interest fall; yield in the market and yield actually obtained will be approximately equal, only, if the rates of interest in the market remain unchanged.

While Tables No. 9, No. 10 and No. 11 should not be examined from the view of determining the *absolute* performance of a portfolio, they do serve as a useful guide in determining the *relative* performance of each of the classes of securities during the 10-year period.

Although it would not be correct to state, categorically, that OMERS could have increased its return by 0.93% per annum during the 10-year period if the System had invested in marketable securities as outlined in Tables No. 9, No. 10 and No. 11, it is reasonable to conclude that OMERS could have increased the return on the System's investments, by a considerable amount, had such an investment policy been followed.

Rates of return on securities vary, of course, with the period of time selected. The returns on each of the classes of securities on Table No. 9, were determined, for instance, for the 20-year period ended on December 31, 1972. The relative rates of return for this period were, essentially, the same as the returns on Table No. 9.

For instance, the spread between the yield in provincials and the yield on municipals, corporates and mortgages (conventional) was .31%, .23% and 1.63% respectively—while the rate of return on common stocks (based on the average annual compounded rate of return method and the TSE's industrial index) was 10.44% per annum.

Rates of Return on Canadian Pension Funds

The question arises, "Could OMERS' funds be invested in such a way as to exceed the *average* returns available in the market over a reasonable period of time?"

The answers received by the Study Group to the question, as might be expected, were not unanimous.

Some of the experts who were consulted, for instance, expressed the opinion that an investment manager must *"keep running just to keep even with the market averages"*.

However, if the investments of a pension fund are invested in slightly higher "risk-reward" investments, returns will be increased; and, if funds are switched from one class of security to another class of security, as economic or financial conditions indicate, rates of return can be increased.

Another question arises, "What rates of return did the investment managers of pension funds in Canada achieve during the 10-year period ended in 1972?"

The data required to answer this question are not available. For instance, Statistics Canada's report on the financial aspects of trusteed pension plans makes no reference, whatever, to rates of return.

However, significant information is available—on a private and confidential basis. A number of firms appraise the performance of Canadian pension funds—including many of the largest funds. The performance of such funds is available, on a code basis, to the funds who participate in the appraisal.

Some of this data was examined. The data indicates that the great majority of Canadian pension funds, until very recent years, have not been managed, effectively. Many funds, for instance, until the mid 60's or later, were invested, exclusively, in bonds and debentures.

However, during the mid 60's and later, some of the larger and the more progressively managed Canadian pension funds, (a) engaged qualified, trained and effective investment managers; (b) broadened their investment policies to include industrial, commercial and residential mortgages, common stocks and, most recently, real estate developments and other enterprises, on either an equity basis or on an income participation basis; and (c) engaged the services of an independent firm to monitor the performance of their investment managers of other pension funds.

On the basis of an examination of the above-mentioned data and, after discussions with investment counsel and others, the Study Group concluded that, in more recent years, **the average Canadian pension fund has achieved a rate of return, approximately, equal to the market averages; while the funds with the more gifted and the more aggressive investment managers have, consistently, achieved rates of return greater than the averages.**

Advisors to the Study Group have stated that funds with aggressive investment managers have exceeded the McLeod, Young, Weir 40-bond index by from ¼ of 1% to ½ of 1% and the Toronto Stock Exchange's industrial index by from 1% to 1½% on a reasonably consistent basis!

Rates of Return in today's Market

What rates of return are being achieved in the market, today? How do these rates compare with the rate on the non-marketable Ontario debentures?

	January 31, 1974
Long-term Province of Ontario bonds, plus ⅛ of 1%	8.62[1]
Provincial bonds	8.50 to 8.80
Municipal debentures	8.75 to 9.15
Corporate bonds	8.75 to 9.50
Mortgages	10.00 to 10.25

[1]If OMERS' investment income were to be based on long Ontarios as of January 31, 1974, the System would receive interest at the rate of approximately 8.62%. (HEPC 8½% due November 30, 1998 yields 8.50%)

It will be noted that, at the present time, marketable bonds and debentures return from ⅛ of 1% to 1.0% more than the non-marketable Ontario debentures; while mortgages return, at least, 1½% more. It is not possible to indicate the return on common stocks at a given time. For instance, during the year 1973 several factors served to depress common stock prices—as a result, the TSE's common stock index (adjusted to include dividend income) was unchanged, basically, from a year ago.

On balance, yields available in the market today on debt securities and the historical return on common stocks (over a reasonable period of time) support the conclusion (reached after analysing the 10-year period ended in 1972) that OMERS could achieve a higher return if the System were to be authorized to invest in marketable securities.

Future

What of the future?

The relative spread between the returns on the non-marketable Ontario debentures

and on marketable securities in the Canadian capital markets experienced during the 60's and the early 70's is a reasonable guide for the future.

Summary

The Study Group is satisfied that OMERS' return on marketable securities should be greater than OMERS' return on non-marketable Ontario debentures.

The Study Group is reluctant to assign numbers to OMERS' greater return from a conventional portfolio of marketable securities rather than non-marketable Ontario debentures. However, **the Group is of the opinion that the OMERS' return could be increased from a minimum of, say, 3/4 of 1% per annum to a maximum of, say, 1-1/4% per annum—the actual return would depend, primarily, on the quality of OMERS' management; on OMERS' investment policies and on the abilities of OMERS' investment managers.**

Caution

The Group wishes to emphasize, most emphatically, that

(a) **the achievement of a greater rate of return would not be automatic**—much hard work by policy makers and skilled investment managers would be required—nor would

(b) **the effect of a greater rate of return be immediate**—OMERS' investment in lower-yielding, non-marketable debentures is large and, therefore, the impact of higher-yielding, marketable securities would not be reflected in OMERS' total rate of return for a number of years.

6 Significance to OMERS of an Increased Rate of Return on Investments

Introduction

The Chapter commences by pointing out that, in recent years, OMERS has earned "excess" investment income and that, primarily, because of this "excess" income OMERS has increased basic pension benefits on four occasions in recent years.

A rule of thumb which is used to indicate the impact of "excess" investment income on a pension fund is stated (increase benefits; reduce contributions).

The impact of inflation on OMERS' pensions is discussed, including an estimate of the additional contributions required (on the basis of certain rates of investment income and of annual salary and wage increases) to provide (a) OMERS' basic pension benefits on the basis of earnings at or near retirement and (b) to protect the purchasing power of OMERS' pensions after the member retires.

The Chapter concludes with a statement that if OMERS is to increase pension benefits, increased income from investments will be very significant to the System.

OMERS "excess" investment income and its allocation

The revenues of a pension fund are derived from contributions of employers, contributions of members and investment income (interest, dividends, etc.).

Therefore, an increase in investment income of a pension fund would make possible, (a) a reduction in contributions or (b) an increase in pension benefits.

For example, in the case of OMERS, investments, at the present time, total \$503,000,000. The weighted average rate of interest on these investments is 7.80% per annum, compounded half-yearly.

The rates of the employer and member contributions to OMERS, at the present time, are based on an assumption that the investments of the System earn 5.50% per annum.

As a result, OMERS' investment income is, currently, 2.3% per annum (7.80% 5.50%) in excess of the assumption.

Primarily, because of such "excess" investment income, in recent years, OMERS has increased the amount of basic pension benefits as follows:

> **January 1, 1968**
>
> **An increase of 10% in basic pension benefits—from 2% of career earnings to 2.2% of such earnings**

December 31, 1970, 1971 and 1972

An increase of 10%, 5% and 5% in the amount of basic pension benefits earned, including basic pensions being paid as of each of these dates.

These increases in pension benefits have contributed, substantially, in recent years, to the maintenance of the purchasing power of OMERS' basic pension benefits.

Rule of thumb to indicate the impact of "excess" investment income

Actuaries have developed a rule of thumb (a general principle only, to be based on the fund's experience and practice) to indicate the impact of future excess investment income on a pension fund—if the income to be earned is to be on a continuing basis.

The rule, as it applies to OMERS, is as follows:

An increase of 1% in the rate of return on OMERS' investments, during the lifetime of the members, would produce sufficient additional income to either,

(a) increase OMERS' pension benefits by about 20%, or

(b) reduce OMERS' contributions by about 18% (which would be equal to 2 per cent of a member's earnings).

Impact of inflation on OMERS

However, at the present time, the most serious problem before OMERS (and before every other Canadian pension fund) arises from the impact of inflation—at increasingly higher rates—on

(a) the amount of OMERS' pensions being accrued and payable at the members' normal retirement dates, and

(b) the purchasing power of OMERS' pensions after they commence to be paid.

Ideally, as a protection against inflation,

(a) a pension should be determined on the basis of earnings at or near retirement, and

(b) the purchasing power of a pension should be protected by increasing the pension, each year, by the use of an index, such as, Statistics Canada's consumer price index.

Pensions based upon earnings at or near retirement, the cost thereof

OMERS' present rates of contributions, plus investment income at the rate of 8% per annum, would not be sufficient to fund a pension based on earnings at or near retirement (2% of final average earnings, integrated with the CPP) if current annual rates of salary and wage increases (productivity, promotion and inflation) continue into the future—these rates, at the present time, are, probably, in the range of 10% to 11% per annum.

An additional 3 per cent of earnings would be required to convert OMERS' basic pension benefits to such an earnings at or near retirement formula—on the basis of an investment income of, at least, 8% per annum and annual rates of salary and wage increases of less than 8% per annum.

Protection of purchasing power of pensions after retirement, the cost thereof

If the purchasing power of OMERS' pensions after the member retires is to be protected, further contributions would be required—in the order of 8 to 9 per cent of earnings—if recent rates of inflation continue in the future (9.2 per cent from December '72 to December '73).

Summary

It is apparent that, if OMERS is to increase the level of the System's pension benefits on the lines outlined in this Chapter, the Sytem will require substantial increases in revenue. Increased revenue, as indicated earlier, can come, only, from (a) the taxes and other revenues of the municipalities, local boards or local institutions, (b) the earnings of the members or (c) the System's investment income.

Therefore, OMERS has a very significant stake in the introduction of a policy which would increase the System's investment income.

7 OMERS and the Canadian Capital Markets

The Study Group's terms of reference require the Group to report on the effect on "the Canadian securities market" of the alternative investment policies for OMERS.

OMERS' present investment program provides that OMERS' funds be invested, exclusively, in non-marketable Ontario debentures.

The savings of OMERS' members and of their employers are invested, without exception, in the public sector of the Ontario economy—as determined by the Government of Ontario and by the Legislature. OMERS is not authorized to invest in opportunities in the private sector. Therefore, OMERS' investment program does not contribute, directly, to the functioning of the Canadian capital markets. It must be pointed out, of course, that to the extent the Province of Ontario secures a portion of its capital fund requirements from OMERS, Ontario's borrowings in the public capital markets are reduced.

However, if OMERS were to be authorized to invest, as other pension funds in Ontario are authorized to invest—under the terms of The Pension Benefits Act—OMERS would become a major direct participant in the market for Canadian securities and the savings of the System's members and employers would become a significant factor in the private sector's investment and economic stabilization processes.

How significant would OMERS' participation in the Canadian capital markets be? To what extent would OMERS' participation affect the market? These questions may be answered by comparing the amounts of the classes of securities which are sold in a single year in the markets with the amount of OMERS' funds which are available in a single year for investment.

The following table indicates the size of the Canadian market for new investments in the year 1972:

	1972 $ Millions
Net new security issues payable in Canadian and foreign currencies (1)	
• Bonds, commercial paper and other short term debt securities	6,762
• Common and preferred stock	568
• Net new non-government investment in mortgages	4,028
	$11,358

The following are a few further indications of the size of the Canadian market

- The amount of outstanding Government of Canada direct and guaranteed securities, excluding Canada Savings Bonds, at the beginning of December, 1973, was $19 billion.[1]
- The total value of trading on the 6 Canadian stock exchanges for the year 1973, according to preliminary estimates, was $9,426 million.

The amounts of OMERS' funds which will be available for investment have been estimated to be as follows: $120 million in 1974; $213 million in 1979; $311 million in 1984 (see Table No. 3).

$125 million as a percentage of $11,358 million	1.1%

The above amounts place the relative size of the Canadian market for securities and OMERS' funds to be available for investment into perspective.

On the basis of these amounts and, on the assumption that OMERS' funds available for investment would be allocated to every section of the Canadian capital market, it is reasonable to assume that the investment of OMERS' funds in the capital markets, insofar as size is concerned, would not give rise to a significant effect on the market.

[1]Sources:
Bank of Canada, Monthly Review
Statistics Canada, Financial Flow Accounts

8 Alternative Investment Policies for OMERS

Introduction

This Chapter commences with a comment on the Study Group's interpretation of its terms of reference.

The remainder of the Chapter is devoted to a discussion of OMERS' investment alternative—(a) non-marketable Ontario debentures on the bases of (i) the present principles for the determination of the rate of interest, and (ii) different principles; (b) Ontario municipal debentures; (c) marketable Ontario bonds and debentures and (d) investments under The Pension Benefits Act.

Terms of Reference

The Study Group's Terms of Reference require the Group to study and to report with regard to "alternative investment programs and an appraisal thereof" (see Table No. 1).

Before proceeding to discuss alternatives to OMERS' present investment policy, the Group points out that there are two aspects to the Terms of Reference, namely to "identify" alternatives and to "appraise" them.

The appraisal of alternatives will consist, essentially, of determining if the alternative investment policies are in the "best interests" of OMERS. Insofar as the Study Group is concerned, the best interests of OMERS (from an investment program point-of-view) will be served by the investment, or by the combination of investments, which produces for OMERS the highest rate of return on the System's investments, consistent with safety of principal and sound investment practices.

Non-marketable Ontario debentures using the present principles for the determination of interest

The non-marketable Ontario debentures which have been issued to OMERS are described and discussed in detail in Chapter No. 3.

The rates of return on the non-marketable Ontario debentures as compared to the rates of return on marketable debentures in the Canadian capital markets (including marketable Ontario debentures) are discussed, at length, in Chapter No. 5.

The conclusion of Chapter No. 5 is that "OMERS' return could be increased from a

minimum of, say, ¾ of 1% per annum to a maximum of, say, 1¼% per annum (if OMERS' investment policy were to be changed from non-marketable Ontario debentures to a conventional portfolio of marketable securities)".

Therefore, OMERS' best interests would be served by the authorization of a program to phase out the non-marketable Ontario debenture as an investment for OMERS within a relatively short period of time.

Non-marketable Ontario debentures using different principles for the determination of interest

The Study Group examined the alternative of OMERS continuing to invest in non-marketable Ontario debentures—using a different principle for the determination of interest.

For instance, the rate of interest could be related to rates of return which OMERS could obtain in the Canadian capital markets on a conventional portfolio of securities (see Chapter 5).

Such a principle could be applied, theoretically, on the basis of a hypothetical portfolio of securities; rates of return; investment weightings; etc. The securities, returns and weightings could be altered, periodically, during a year, say, quarterly—as determined by the Board of OMERS—on the advice of an outstanding investment counsel.

By the use of such a hypothetical portfolio of securities, a rate of return could be calculated which would represent the rate of return which OMERS could have obtained in the public markets. The rate of interest on the non-marketable Ontario debentures could be related to such a rate of return.

However, if such a principle were to be adopted, OMERS and Ontario would be faced with the task of developing a model; of maintaining the model; of selecting an investment counsel; etc.; and of satisfying the employers and the members of OMERS that the principles of the model were working in the interests of OMERS.

Ontario Municipal debentures

The Study Group's terms of reference require a report on the effect of alternative investment programs on *"the market for Ontario municipal debentures, including the cost of long term money to the municipalities".*

Spokesmen for certain of the Ontario municipalities—(the municipalities contribute, at least, one-half of OMERS' contribution income and, in many cases, much more)—have recommended that OMERS be authorized to invest in the debentures of the Ontario municipalities. One of the reasons for Mr. John White's initiative in the establishment of the OMERS Joint Study Group was that this recommendation be studied, thoroughly.

Before proceeding to discuss the recommendation, it is relevant to examine the trend of the sources of the capital funds borrowed by the Ontario municipalities (and school boards) during recent years.

The sources of these capital funds were as follows:

	Ontario Programs or Agencies		Canada Programs or Agencies		Public Securities Market		
Year	Amount	Percentage of Total	Amount	Percentage of Total	Amount	Percentage of Total	Total
			in millions of dollars				
'56	$ 4	2%			$161	98%	$165
57	20	10			175	90	195
58	27	12			194	88	221
59	25	11			210	89	235
60	26	11			212	89	238
61	16	8			198	93	214
62	27	12	$ 3	1%	193	87	223
63	24	10	6	3	212	88	242
64	27	10	23	8	225	82	275
65	26	10	36	14	197	76	259
66	130	38	51	15	165	48	346
67	188	48	47	12	155	40	390
68	212	57	36	10	122	33	370
69	164	55	22	7	110	37	296
70	210	57	33	9	123	34	366
71	220	55	29	7	153	38	402
72	147	45	35	11	146	45	328

The summary discloses that, in recent years, the Province of Ontario and its agencies (Ontario Municipal Improvement Corporation, Ontario Education Capital Aid Corporation, Ontario Water Resources Commission, etc.) have provided an increasingly larger portion of the municipalities' capital funds which, in earlier years, the municipalities had been required to borrow in the public capital market. Ontario's portion increased from 2% of the municipalities' capital fund requirements in 1956; to 11% in 1960; to 57% in 1970 and to 45% in 1972—substantial increases, indeed!

These capital funds, the most of which have been loaned at "subsidized" rates of interest; have reduced, sharply, as the summary discloses, the municipalities' dependence on the public capital market—from 98% of the municipal capital fund requirements in 1956 to 45% in 1972.

Now, to proceed to discuss the municipal recommendation!

What amount of OMERS' funds would be available for investment? What would be the capital fund requirements of the Ontario municipalities (and school boards)?

An answer to the first question appears in Table No. 3. An answer to the second question was provided by the Municipal Committee of the Investment Dealers Association of Canada. (At the request of the Study Group, the Committee prepared a position paper on (a) the market for Ontario municipal debentures and (b) the effect on the market of an allocation of all, or of a portion, of OMERS' funds to the purchase of municipal debentures.)

The answers to the questions are as follows:

in millions of dollars

	'74	'75	'76	'77	'78	'79	'80	'81	'82	'83
OMERS' funds available	$120	137	153	167	188	213	231	251	271	291
Municipalities' requirements	$168	176	185	194	204	214	225	236	248	260

According to these estimates, OMERS' funds would be sufficient to provide 72% of the municipalities' capital fund requirements in '74 and would provide progressively larger portions until OMERS would provide 100% of their requirements from '79—into the foreseeable future.

The question to be raised, of course, is "Would the best interests of OMERS be served by the investment of the System's funds, exclusively, in Ontario municipal debentures?"

Tables No. 9 and No. 10 disclose that, while the return on municipal debentures is greater than the return on provincial and corporate bonds, such a return is much less than the return on mortgages or on common stocks.

In addition, if all of the funds of OMERS were to be allocated to the purchase of Ontario municipal debentures, the spread in yield between provincials and municipals would soon disappear; the public market for such debentures would soon disappear and an artificial market, with arbitrarily-determined purchase prices, purchase terms, etc. would have to be established. OMERS would be required to establish and to administer the prices, terms, etc.

Therefore, it may be stated, categorically, that the best interests of OMERS would not be served if the System's funds were invested, exclusively, in Ontario municipal debentures.

However, a further question arises, namely, "If a portion of OMERS' funds were to be invested in Ontario municipal debentures, could the best interests of OMERS be served?" and, further, "Would such an investment policy contribute to the development of an improved market for Ontario's municipal debentures?"

First, it must be stated that the great majority of Canadian pension funds do not invest in municipal debentures. The reasons are well known—the municipal debenture, generally, has been a serial debenture and, therefore, its handling and its bookkeeping costs have been relatively high. In addition, with a few exceptions, there has been, essentially, no secondary market for municipal debentures.

These unfavourable factors could be reduced in significance in future years because (a) of the transfer, recently, of the responsibility for municipal capital borrowing from small local municipalities to much larger area municipalities and (b) of the availability of the more marketable debentures which Ontario's area municipalities were, recently, authorized to issue.

The investment of OMERS' funds in Ontario municipal debentures could be in the interests of OMERS if (a) the amount of the funds allocated by OMERS to the purchase of such debentures did not distort the normal public market for the debentures, (b) OMERS' investment managers were free to purchase, or not to purchase, such debentures and (c) accepted principles of investment were to be used.

What level of allocation of OMERS' funds to the purchase of Ontario municipals would distort supply and demand and, therefore, would distort the market? The answer, obviously, is a matter of opinion. However, the opinions of the Municipal Committee of the Investment Dealers Association of Canada and of the other persons who were consulted were unanimous on this question—an allocation of slightly less than 20% of OMERS' funds would not distort the public market.

Such an allocation of OMERS' funds would be substantial, indeed, i.e. a sum of approximately $24 million in 1974 rising, consistently by $2 or $3 million a year!

However, the hazards to OMERS of such an investment program must be emphasized, emphatically!

OMERS' purchases should not be permitted to dominate the market for Ontario municipal debentures! OMERS' purchases should not be permitted to place this public market in jeopardy! OMERS' purchases should not be in such a volume as to cause a relative decline in the yield on these debentures. The development of any of these factors would not be in the best interests of OMERS.

As the Treasurer of Ontario stated in the Legislature on December 6, 1973, *"It would be no more fair to ask the OMERS participants to subsidize the municipalities than it would be to ask them to subsidize the Province of Ontario".*

To conclude, since the rate on Ontario municipal debentures, historically, has exceeded the rate on OMERS' special Ontario debentures (see Table No. 9) investment by OMERS in Ontario municipal debentures, as a part of a conventionally-balanced portfolio of marketable securities, subject to the elimination of the hazards described in this section, could serve the best interests of OMERS.

Insofar as the Ontario local governments are concerned, such an investment program by OMERS would improve the tone of the market for the Ontario municipal debenture; contribute to the establishment of a secondary market; and tend to stabilize the cost of long term money to the municipalities—particularly, during periods of high demands for money.

Marketable Ontario bonds and debentures

There is a similarity between the question of OMERS' investment in Ontario municipal debentures and of OMERS' investment in Province of Ontario marketable bonds and debentures; (assuming that OMERS were to be authorized to invest its funds in a conventionally-balanced portfolio of marketable securities under The Pension Benefits Act).

OMERS' direct investment in Ontario non-marketable debentures represents a significant source of "internal" capital funds to Ontario; reduces Ontario's dependence on the public capital market; and, reduces the cost of capital funds to Ontario—to some degree.

If OMERS' monies were to be invested in a manner similar to the monies of many other pension funds in Canada, a portion of its funds would be invested (buy, hold, trade) in marketable provincial securities. For instance, in the weighting of an investment portfolio, which is illustrated on Table No. 11, 25% of the funds are allocated to provincial bonds.

If OMERS were to be free to adopt such policy, and were to invest the bulk of the allocation (say, 20%), in the purchase of marketable Ontario securities, substantial sums could be made available to support the public market for Ontario's securities. The amounts to be available, for the years 1974 to 1983, would be as follows:

Year	Amount	Year	Amount
	in millions of dollars		
'74	$24	'79	$43
75	27	80	46
76	31	81	50
77	33	82	54
78	38	83	58

Such a substantial investment by OMERS in Ontario's marketable securities would be a far cry, however, from OMERS' present unconventional investment in the non-marketable Ontario debentures.

If OMERS were to be authorized to invest under The Pension Benefits Act and if the System were to allocate 20% of its funds to the purchase of marketable Ontario debentures purchased in the public capital market, the Province would, of course, be required to increase its borrowings in the capital markets (or to reduce its expenditures; or to increase its taxes).

Ontario's public borrowings would be increased by the difference between the annual amounts of OMERS' funds which would be available for investment (see Table No. 3) and the amounts of Ontario marketable securities which would be purchased by OMERS in the public markets (see the 3rd preceding paragraph).

On the basis of the estimate of the funds to be available for investment and the amounts to be invested, the additional sums to be borrowed by the Province of Ontario in the public market would be as follows:

Year	Amount		Year	Amount
		in millions of dollars		
'74	$ 96		'79	$170
75	110		80	185
76	122		81	201
77	134		82	217
78	150		83	232

If Ontario were to be required to borrow such sums in the public market rather than from OMERS, the supply of the Province's securities in the market would increase, and, as a result, there would be a tendency for the price of money to the Province to increase.

The probability of an increase in the cost of long term money to Ontario highlights the significance of one of the prime questions with which the Study Group has been faced, namely,

"Should the funds of OMERS

(a) be dedicated to:

(i) a reduction of the impact of Ontario's borrowings on the public capital market

(ii) a reduction in the cost of Ontario's long term money, and

(iii) the enhancement of Ontario's credit, or

(b) be dedicated, exclusively, to

(i) the interests of the employers and the members of OMERS."

The Pension Benefits Act

As indicated in Chapter 4, the Regulations under The Pension Benefits Act prescribe, in detail, the classes of investments in which pension funds in Ontario may be invested.

Other pension funds in Ontario (and, certainly, the more progressively-managed funds) with the exception of a few funds in the public sector, to take advantage of the

investment opportunities which exist in every sector of the Canadian capital markets, invest in a complete range of securities, i.e. bonds, debentures, mortgages, common stocks and in other investment opportunities as described in Chapter 4.

On the basis of the Group's studies and its discussions with experts and advisers, the best interests of OMERS would be served if the System were to be authorized to invest its funds in accordance with the terms of The Pension Benefits Act and the Regulations thereunder; and in accordance with the investment philosophies and the investment practices of the more progressively-managed pension funds in Ontario, other Canadian provinces, the United States and Great Britain.

If OMERS were to be so authorized, the effect of such a change in its investment program would be extremely significant.

The impact of such an authorization on the rate of return on OMERS' investments is stated in the second last section of Chapter 5.

9 Opinions of the Municipalities, School Boards, Members of OMERS and others

Introduction

This Chapter commences with a summary of the dialogue which has taken place between members of the Government of Ontario and the Board of OMERS, on the one hand, and associations of municipalities and local boards and their officers and employees, on the other.

The positions of these municipal associations, officers, employees and others, with regard to OMERS' investment policies, are summarized by quoting, extensively, from resolutions and correspondence.

The Chapter concludes with a statement of the unanimous opinion of the investment specialists who were consulted by the Study Group and the unanimous opinion of these associations, officers, employees and others.

The Dialogue

In recent months a very intensive dialogue with regard to OMERS' investment policies has taken place (formal resolutions; correspondence from associations; and meetings between the Premier, the Treasurer and Minister of Economics and Intergovernmental Affairs, the Minister of Education, members of the Cabinet and members of the Legislature, the Board of OMERS and associations of municipalities, school boards, their officers and their employees).

As a part of its program of direct consultation, the Study Group requested many of these same associations to submit, with more specific detail, their ideas and their suggestions with regard to the pros and cons of OMERS' present investment policies.

In addition, at the request of the Group, the Municipal Liaison Committee arranged for the Group to hold discussions with a number of municipal treasurers who are experienced in the investment of pension funds.

Position of Associations, Officers, Employees and Others

The position of these associations and these officers is illustratd best, perhaps, by a joint submission to the Government of the 3 associations of the municipalities of Ontario (the Association of Municipalities of Ontario; the Association of Counties and Regions of Ontario; the Association of Rural Municipalities of Ontario) under date of April 17, 1973.

The joint submission of the 3 associations contains the recommendation that *"the OMERS Board be authorized to develop more diversified investment policies to obtain the highest possible return from the contributions of the fund"* and the further recommendation that the *"municipalities have access to OMERS' funds"*.

The Association of Municipal Clerks and Treasurers of Ontario was the first association to question OMERS' investment policies; followed, closely, by the Ontario Municipal Personnel Association. Both of these Associations supported the position of the 3 associations of municipalities and rendered technical advice to the associations' officers.

The Ontario Society of Medical Officers of Health has supported the position of the associations of municipalities.

Insofar as the school boards are concerned (29% of the members of OMERS are non-teaching employees of school boards) the Ontario Association of School Business Officials has supported, strongly, the position of the associations of municipalities. The school business officials' position has been supported, in principle, by The Ontario School Trustees' Council (which is an alliance of 4 trustees associations).

The Ontario Division, Canadian Union of Public Employees, supports the position of the municipal associations, as does the Police Association of Ontario.

The position of all of the associations was not stated in identical terms, of course.

(a) The postion of the Advisory Committee of Municipal Treasurers (to the Association of Municipal Clerks and Treasurers of Ontario) is thorough and, because of its significance, is reproduced, in part, as Table No. 13. The essence of the Committee's position is stated in the following sentences: *"The Committee felt that the first matter to be resolved was that there should be an acceptance by all concerned that the primary objective of the fund was to ensure that the best interests of its members was being served, rather than the interests of either the municipalities or the province." "The Committee felt that the primary objective in the management of OMERS' assets should be to maximize investment income, while maintaining the safety and the purchasing power of the assets."*

(b) Another position (the Pension Committee of the Canadian Union of Public Employees—Ontario Division) reads, in part, as follows: *"good management (of investments) includes—the diversification of investments between equities and fixed incomes"; "social needs—could be partially overcome by—(a) (apportioning) 1% of the—funds—to low-cost, co-operative housing; and (b) (investing) a portion of the funds in stock issues of companies operating in Ontario which are foreign controlled"*.

(c) A further position (Canadian Union of Public Employees, Local One) reads, in part, as follows: *"the present monies in OMERS and future contributions be freed from the restrictive investment policy now in effect—that all monies available—be allowed to compete in the open market, subject to—The Pension Benefits Act of Ontario".*

(d) A further position (Ontario Association of School Business Officials) reads, in part, as follows: *"The Board of OMERS be permitted to obtain the highest possible return—consistent with good investment practices"; "every reasonable investment avenue should be considered".*

(e) The Ontario Municipal Personnel Association, in a letter to the Premier, states that, *"an aggressive investment portfolio"* could reduce the costs of pensions *"substantially"* and the result would be *"in the best interests of the municipal employee, the municipal employer and the municipal tax-payer"* and in a letter to the Study Group, states *"to place all of the funds in special non-saleable Ontario debentures is not the answer, nor is placing all of the funds in municipal debentures the answer." "OMERS requires a flexible investment policy which can take advantage of the market." "We must be concerned with costs and the net return to the fund at the highest possible level".*

(f) The position of the Police Association of Ontario is cautious and expresses pleasure that the Study Group has been established and confidence that *"our Legislators will not change the existing legislation without sound reasoning and grave concern for those who are participating in the System".*

It is essential to remember that the investment policies of certain of the "approved pension plans" of the major Ontario municipalities had been criticized, in the early 70's, because of policies which, according to the critics, were not in the best interests of the members of the plans.

For instance, the Metropolitan Toronto Police Association, in large advertisements in the Toronto newspapers, criticized the "restrictive investment policies of the Trustees" which denied to the pension plan "very substantial gains".

In support of the Association's position, the Toronto Globe and Mail on January 22, 1970, expressed the editorial opinion that *"the policemen's pension fund should be operated in the best interests of the policemen and investment decisions should not be influenced by the financing needs of the municipality" (Metropolitan Toronto).*

It is to be noted that, subsequent to these criticisms, Toronto's civic and fire plans; Metropolitan Toronto's civic and police plans; and Ottawa's superannuation plan have been authorized, by the councils responsible, to invest in a broader range of securities.

Summary of Opinions

Every investment specialist whom the Study Group consulted (investment dealers, managers of the investments of pension funds, investment counsel and others) was of the opinion that, the best interests of the employers and the members of OMERS would be served if the monies of OMERS were invested, as other pension funds are invested—with minor exception, in marketable securities of the Canadian capital market.

Every municipal association, officer (including the municipal treasurers) and individual, whose correspondence the Study Group examined, or with whom the Group corresponded or held discussions, expressed the opinion that The OMERS Act should be amended, to permit, in effect, the savings of the employers and the members of OMERS to be invested in their best interests—as other pension funds in Ontario are invested—under the terms of The Pension Benefits Act of Ontario.

It is to be noted that the joint submission of the 3 associations of municipalities recommended that the "municipalities have access to OMERS' funds". The position of some of the other associations refer to investment of OMERS' funds in Ontario municipal debentures—the majority do not.

10 Issues Which Could Arise

Introduction

The Chapter commences with a statement of the differences between OMERS' investment policies and those of other pension funds. The prime reason for the establishment of OMERS' investment policies is stated.

OMERS' increasing maturity and the factors which gave rise to the need to appraise the System's investment policies are described.

An issue which could arise, if OMERS' present investment policies are to be continued, indefinitely, is discussed, i.e. the Province's role as the custodian of OMERS' funds.

The Chapter concludes with comments on the suggestion that the Province guarantees the payment of OMERS' pension benefits.

Investment policies of OMERS and of other pension funds

OMERS' investment policies, as described in Chapter 4, differ from the policies of pension funds in the private sector and in the public sector—with a few exceptions. OMERS' monies, at the present time, are invested in non-marketable Ontario debentures, while other pension funds' monies, with a few exceptions, are invested in marketable securities—at higher rates of return.

Why do OMERS' investment policies differ?

OMERS' investment policies differ because the Government of Ontario, in 1962, as is discussed in Chapter 3, accepted a recommendation that special, long-term, non-marketable Ontario debentures be issued in order to establish a retirement system for Ontario's municipalities and local boards—at uniform, stable and reasonable rates of contributions—regardless of the age or the sex of the employee and regardless of the size or the location of the local government, board or institution—and thereby, dispose of one of the Government's most pressing and, increasingly complicated, municipal finance problems.

OMERS' special Ontario debentures have served the interests of the System very well.

Need to Appraise OMERS' Investment Policies

However, in the early 70's, as OMERS' acceptability became assured; as OMERS' actuaries accumulated reliable data with regard to the members' age, sex, disability, retirement, mortality, etc; and as the System matured and stabilized; it became apparent that OMERS, insofar as investment policy was concerned, should commence to

concern itself, less with acceptability and less with stability, and more with the rates of return on investments. **As with all children, OMERS' need for its parent—the Province of Ontario—appeared to be coming to an end;—the parent's support, which was essential and was adequate in year one, was no longer essential and was less than adequate in year ten.**

And so, it became apparent, in the early 70's, that OMERS was approaching the time when the System needed to appraise its investment policy and needed to determine if a level of acceptability, stability and maturity had been reached which would permit OMERS to seek greater rates of return—by a change in investment policy.

The Board of OMERS, a few years ago, submitted reports which recommended that The OMERS Act be amended to permit the System to invest its funds in securities authorized by The Pension Benefits Act and the Regulations thereunder.

Is the Province the Trustee of OMERS' funds?

Is the Province of Ontario the trustee of OMERS' funds? Is so, are the Province's duties the same as the duties of any other trustee? What are the duties of the trustee of the monies of a pension fund?

The following quotations are illustrative of the pension literature. *"A pension fund trustee acts, exclusively, for the benefit of the employees for whom the fund was established." "It is the employees' funds that the trustee administers and, as a result, a position of trust is established." "A trustee, as fiduciary, has a duty to act in good faith, with care and diligence." "You can't profit from your trust."*

Ontario's Guarantee

The suggestion has been made, in some quarters, that since the Province of Ontario would guarantee OMERS' pension benefits if the System were to be unable to pay the members' pensions, the monies of OMERS should be loaned to the Province—in spite of a loss to OMERS of doing so!

Does the Province of Ontario guarantee OMERS' pensions? Is the Province obligated to discharge OMERS' liabilities if the System were to be unable to do so? What are the probabilities of OMERS being unable to do so?

There is no section in The OMERS Act which states that the Province of Ontario is to provide monies to pay OMERS' pensions if the System were to be unable to do so! As a matter of fact, Section 10 of the Act provides that, *"the contributions of the employers shall be such an amount as is required, in addition to the contributions of the*

members and the interest earned—to provide for the payment of the benefits and expenses—".

In other words, under Section 10 of the Act, the municipalities and the local boards of Ontario, as "employers", under The OMERS Act, are obliged, specifically, to discharge OMERS' liabilities.

What would the probabilities be of the Province being called upon to guarantee OMERS' pensions? If OMERS' funds were to be invested under the terms of The Pension Benefits Act—in a conventionally diversified portfolio of Canadian securities—the probability of such an eventuality would appear to be remote, indeed!

It is a finding of the Study Group that the Province of Ontario's position as the custodian of OMERS' funds should be reviewed, carefully.

11 Significance of Organization and Personnel

Introduction

In this Chapter, the Study Group's final Term of Reference is discussed, namely the effect on "OMERS' organization and administrative expenses" of an "alternative investment program".

The management of a large portfolio of investments and principles to be used in its management are discussed, including an organizational structure for the establishment of investment policy, management and administration.

The comment is made that in OMERS' best interests, the System should not commence to invest all monies in marketable securities as of a specified date and, in the interim, the monies not invested in such securities be invested in Ontario debentures.

The costs to OMERS of an investment management organization are discussed.

The Chapter concludes with a statement of the significance to the Treasurer of Ontario and to the Board of OMERS being authorized to invest in marketable securities.

Work Involved

If OMERS were to be authorized to invest in a portfolio of marketable securities, the System would be required to:

(a) secure the services of persons, with special training, experience and skills, at the policy, the management and the administrative levels; and

(b) develop an organization to:

- establish and, constantly review, investment policy
- monitor, constantly, investment performance
- develop, continuously, and execute investment policy and investment strategy, and
- administer the purchase and sale of investments, the custody of investments, the receipt of investment income, etc.

The Study Group requested Mr. James P. Marshall, a consultant on organization for the management of money, to comment on this aspect of the Group's assignment. This section of the Report reflects, to a great extent, Mr. Marshall's comments.

Principles to be Used

The following principles should be used as a guide if the OMERS Board is to be

granted the power to invest the System's funds under the terms of The Pension Benefits Act.

(a) Because of the very large and increasing amounts of money involved, (see Table No. 3) OMERS' monies should be invested by an "in-house" money management team.

(b) The investment objectives of OMERS' Board of Management should be to strive (i) for excellence; (ii) for a rate of return in excess of the McLeod Young Weir 40-bond index and the Toronto Stock Exchange's industrial index; and (iii) to recruit an investment management team of outstanding abilities, training and experience.

(c) The persons involved in the management and the administration of OMERS' funds must be organized, very carefully, if OMERS' investment objectives are to be achieved.

(d) OMERS' investment managers must be free to invest, without unnecessary retions, according to their judgements, subject to general policies of the Board's Investment Policy Committee.

(e) The investment performance of OMERS' investment managers should be appraised, regularly, by an independent firm engaged in the measurement of rates of return.

(f) OMERS' Board of Management should be granted, by statute, the authority to delegate to an Investment Policy Committee the power to purchase securities and the Policy Committee, in turn, should be granted the authority to delegate to the investment managers the power to purchase securities, subject to subsequent approval of the Policy Committee.

(g) Investment policy and investment strategy must be based on thorough economic analysis and financial research and on continuous consultations with investment specialists—throughout the investment community. Such analysis, research and consultations are, absolutely, essential if above-average performance is to be achieved.

(h) Because of the competition for high calibre investment managers, OMERS' working conditions must be very good, including, of course, salaries and employee benefits.

(i) Since external influences and distractions should be removed from investment decision-making processes, it would be desirable to locate OMERS' investment department away from OMERS' regular offices and even away from the immediate vicinity of Queens Park.

An Organizational Structure

Table No. 12 illustrates an organization structure designed to establish responsibility and accountability for OMERS' investment policies, strategies and administration. **(The structure is based on the assumption that OMERS has commenced to invest in a complete range of marketable securities.)**

The organization's decision-making structure could be composed of an Investment Policy Committee, an Investment Strategy Committee and an Investment Administration Committee.

The following is a brief statement of the composition, the role and the responsibilities of each committee.

Investment Policy Committee

Composition

- Finance consultant to the Board of OMERS, chairman
- Director of Investments
- 3 senior persons from the investment management community
- Chairman of the OMERS Board, ex officio

Role and responsibilities

- Responsible to the Board of Management for the investment of the System's funds, subject to restrictions imposed by the Board
- Nurture a blend of business-like common sense and of investment management skills within OMERS' investment department
- Formulate, with the advice and the assistance of the System's investment management team, a full range of investment policies, including policies with regard to bonds, debentures, mortgages, stocks, real estate and other investments
- Approve, amend or reject the Investment Strategy Committee's regular recommendations
- Review, thoroughly and objectively, the Committee's investment policies, at least, once every twelve months
- Monitor the performance of the System's investment management team, primarily, by the employment of a firm engaged in the measurement of investment performance.

Investment Strategy Committee

Composition
- Director of Investments
- Director of Economics
- Director of Bonds and Debentures
- Director of Mortgages
- Director of Stocks
- Director of Real Estate and Other Investments

Role and responsibilities
- Develop, regularly, for presentation to the Investment Policy Committee, investment strategy recommendations
- Ensure that strategies, approved by the Investment Policy Committee, are carried out
- Supervise, in a general way, the selection, timing and execution of purchases, sales, exchanges, etc.

Investment Administration Committee

Composition
- Finance Consultant to the Board of OMERS, chairman
- Director of Finance of OMERS
- Several other officers

Role and responsibilities
- Ensure that OMERS' investment managers are shielded from the increasing demands of administrative requirements
- Assume responsibility for the approval of the administrative policies and practices required to sustain and to control the work of OMERS' investment managers, such as accounts, budgets, costs, legal and audit.

OMERS to invest in Marketable Securities in stages

It would not be in OMERS' best interests, for the reasons discussed in this section, for the System to commence to invest all monies in marketable securities as of a specified date—the task to do so would be unthinkable!

The task should be spread over a time frame of, say, five years because of (a) the desirability of building the investment management team carefully and of selecting its members with insight; (b) the very large sums of money; and (c) many other complex administrative factors. Investment counsel and other specialists—such as specialists in the purchase and sale of mortgages—should be engaged by OMERS for the interim period and, perhaps, for longer, to advise, train and assist OMERS' investment managers.

During the interim period, the portion of OMERS' funds which would not be invested in marketable securities, could continue to be invested in the Ontario debentures.

Costs

What would OMERS' costs be to establish and to maintain such an investment organization?

The costs, of course, would depend upon the amount of the pension fund's investments, the composition of the fund's investment portfolio and the extent of the fund's resources—such as economic and financial analysis.

For comparative purposes such costs are stated, usually, as a percentage of the amount of the investments.

A number of enquiries were made with regard to the investment management costs of large Canadian pension funds. These enquiries disclosed that funds with an investment portfolio of from $500,000,000 to $1,000,000,000 are managed at a cost of, approximately, 1/10th of 1% of the value of the portfolio.

On the basis of these enquiries, OMERS' investment management costs have been estimated at 15/100 of 1% (see Table No. 11). (The total amount of OMERS' investments will reach $1,000,000,000 in 3 or 4 years.)

More demanding Responsibilities

OMERS generates one of Canada's largest pools of employer and employee savings.

The investment of these savings in marketable securities would require OMERS—its board of management, its officer corps and its senior employees—to be organized in such a manner and with such persons as could exercise, with skill and effectiveness, specialized and demanding responsibilities.

The management of a very large portfolio of securities would impose an entirely new, more sophisticated, and more demanding responsibility on the Minister responsible to the Government for The OMERS Act (the Treasurer of Ontario and Minister of Economics and Intergovernmental Affairs) and on the Board of OMERS.

However, such a responsibility is being assumed by other Canadian organizations in the public sector—Canadian National, Air Canada and other large Federal crown corporations, Hydro Electric Power Commission of Ontario, etc.—in some cases, with outstanding success!

A Word of Caution

However, if such a responsibility is to be assumed, successfully, the organization of OMERS must be sound; its policy makers must be persons of integrity, maturity and experience; its policies must reflect common sense; its investment managers must be trained, thoroughly, be experienced, possess courage and investment insight!

In the report entitled "Economic Aspects of Pensions", to which reference is made in the last paragraph of Chapter 4, the following comment is made, under the heading "Restraints on Investment Management", with regard to the management of the investment portfolios of the state and local government retirement systems in the United States: *"More imaginative investments policies are inhibited by a number of other factors. Retirement system trustees are not chosen just for their knowledge of, and experience with, investments. They have other important duties to perform as well. The practice of seeking to secure competent investment advice by competitive bidding, the inability to pay adequate salaries for expert staff, and the apparent unwillingness to lay out even very modest sums for investment management are all factors conspiring to produce uninspired and mediocre portfolio management.* **Despite the great progress of recent years, few systems have adequate staffs, strong investment advisory arrangements, effective finance committees, and the capability of providing first-rate management.** *These former sleeping giants of the pension-fund field sometimes appear to be only partially awake."*

12 Acknowledgements

During the course of its work, the Study Group secured advice and assistance from many specialists in investments and in pensions.

In addition, the Group sought the experience and the opinions of municipalities and school boards and their officers and employees.

As stated in the Foreword, the Study Group expresses its sincere appreciation to those who contributed to the Group's understanding of the issues, the principles and the practices which are associated with an appraisal of OMERS' investment policies.

The following organizations rendered either advice, assistance or opinions to the Study Group:

Actuaries

The Wyatt Company, OMERS' actuaries

Investment Counsels

Sceptre Investment Counsel Limited
John R. Ferguson

Investment Dealers

Dominion Securities Corporation Harris & Partners Limited
McLeod, Young, Weir & Company Limited
Wood Gundy Limited
Investment Dealers Association of Canada

Managers of investments

Pension fund of
Hydro Electric Power Commission of Ontario
Employees' savings and profit sharing fund of
Dominion Foundries and Steel Limited

Management of pension fund monies

James P. Marshall

Municipalities and school boards

Municipal Liaison Committee—the Province's liaison with
- Association of Municipalities of Ontario
- Ontario Association of Rural Municipalities
- Association of Counties and Regions of Ontario

Ontario Public School Trustees' Association
Ontario School Trustees' Council

Association of officers and employees

Association of Municipal Clerks and Treasurers of Ontario
Ontario Municipal Personnel Association
Canadian Union of Public Employees
Police Association of Ontario
Ontario Professional Fire Fighters' Association
Ontario Society of Medical Officers of Health
Ontario Association of School Business Officials

Terms of Reference

Table No. 1

Study and report to the Treasurer of Ontario and to the Board of OMERS with regard to the following aspects of OMERS' present and future investment policies and related matters:

(a) the amount of OMERS' funds—basic, prior service, supplementary benefits and administered pension funds—which will be available for investment for each of the next 15 years

(b) alternative investment programs and an appraisal thereof, including the effect of the programs on:

(1) OMERS' rates of return on investments

(2) OMERS' possible future pension benefits

(3) the market for Ontario municipal debentures, including the cost of long-term money to the municipalities

(4) the Canadian securities market, generally, and

(5) OMERS' organization and administrative expenses.

Statement of OMERS' Growth, Past and Future

for the years 1963 to 1988

Table No. 2

Year	Number of Contributors	Number of Pensioners	Amount of Contributions	Amount of Interest Earned	Amount of Pension Benefits and Administrative Expenditures	Amount of Investments
			in millions of dollars			
Actual						
'63	9,840	19	4			4
64	19,272	150	11			15
65	24,018	392	14	1	1	29
66	40,968	726	20	2	2	49
67	48,449	1,224	24	3	2	74
68	55,245	1,787	32	4	3	107
69	64,084	2,502	44	7	4	154
70	71,764	3,489	52	11	5	212
71	80,553	4,565	65	16	6	287
72	86,359	5,752	79	23	11	378
73	92,721[1]	7,028	98	39	12	503
Estimated[2]						
'74			100	40	20	623
75			108	53	24	760
76			119	65	31	913
77			130	76	39	1,080
78			145	90	47	1,268
79			161	105	53	1,481
80			177	123	69	1,712
81			193	141	83	1,963
82			209	162	100	2,234
83			227	183	120	2,524
84			246	206	141	2,835
85			269	231	167	3,168
86			292	256	193	3,523
87			318	286	224	3,903
88			350	316	255	4,314

Notes:

[1]Includes members of the administered pension funds

[2]Estimated by The Wyatt Company, OMERS' actuaries

Statement of OMERS' Investments, Past and Future

for the years 1963 to 1988

Table No. 3

Funds invested or to be invested

Year	Basic Funds	Prior Service Funds	Supplementary Funds	Administered Pension Funds	Total Investments	Funds available for investment
			in millions of dollars			
Actual						
'63					$ 4	$ 4
64					15	11
65					29	14
66					49	20
67					74	25
68					107	33
69					154	47
70					212	55
71					287	75
72					378	91
73					503	125[1]
Estimated[2]						
'74	$ 532	$7	$ 27	$ 57	623	120
75	647	6	34	73	760	137
76	773	6	43	91	913	153
77	910	6	52	112	1,080	167
78	1,063	5	63	137	1,268	188
79	1,237	5	75	164	1,481	213
80	1,423	5	89	195	1,712	231
81	1,624	4	105	230	1,963	251
82	1,837	4	123	270	2,234	271
83	2,062	4	143	315	2,524	290
84	2,302	3	165	365	2,835	311
85	2,556	3	189	420	3,168	333
86	2,825	3	215	480	3,523	355
87	3,113	2	243	545	3,903	380
88	3,404	2	273	615	4,314	411

Notes:

[1]Includes the special interest adjustment of $9,045,170 re the change in the rates of interest on the special Ontario debentures

[2]Estimated by The Wyatt Company

Investments of Trusteed Pension Plans in Canada[1]

Table No. 4

	'62 Amount	'62 %	'66 Amount	'66 %	'71 Amount	'71 %
	in millions of dollars					
Obligations of:						
Canada	$ 607	13%	$ 488	7%	$ 424	3%
Provinces	1,476	33	2,218	31	3,324	27
Municipalities and school boards	461	10	682	9	749	6
	2,544	56	3,388	47	4,497	36
Corporate bonds	713	16	1,099	15	1,889	16
Mortgages	414	9	676	9	1,170	9
Common stocks	479	11	1,167	16	3,127	25
Other assets[2]	380	8	920	13	1,778	14
	4,530	100	7,250	100	12,461	100

Notes:

[1]Includes every pension fund in Canada with invested assets. Excludes Canada's Public Service Superannuation Plan, the RCMP Superannuation Plan, etc.; pension plans for the civil service of Newfoundland, Quebec, Ontario, Saskatchewan and Alberta; those for the teachers of Newfoundland, New Brunswick and Quebec

[2]Includes pooled funds, mutual funds, preferred stock, real estate, cash, short-term investments

Source: Statistics Canada

Investments of Private Non-Insured Pension Plans in the United States[1]

Table No. 5

	'62		'66		'71	
	Amount	%	Amount	%	Amount	%
			in billions of dollars			
Obligations of the United States	$ 2,920	7%	$ 2,750	4%	$ 2,730	2%
Corporate and other bonds	18,100	43	25,230	38	29,010	27
Mortgages	1,880	5	3,910	6	3,680	4
Common stocks	15,730	37	29,070	44	62,780	59
Other assets[2]	3,260	8	5,210	8	8,220	8
	41,890	100	66,170	100	106,420	100

Notes:

[1]Includes funds of corporations, non-profit institutions and multi-employer and union groups

[2]Includes cash, deposits and preferred stock

Source: United States Securities and Exchange Commission

Investments of Private Pension Funds in Great Britain[1]

Table No. 6

	Investment in Ordinary Shares		Net New Investment in Ordinary Shares	
Year	Total Amount	As a % of Total Investments	During the Year	As a % of Total Net New Investments
	in millions of pounds sterling			
'62	1,109	46%		
65	1,593	48	102	37%
68	2,491	58	167	59
69	2,366	55	93	31
70	2,467	53	165	47
71	3,561	58	170	46

Notes:

[1]Excludes pension funds operated by the Central Government, local governments, crown corporations, co-operative societies and insurance companies

Source: Panmure Gordon & Co., London, England

Analysis of the Investment of Ontario's remaining individual municipal pension funds

Table No. 7-1

	1968	1972
City of Toronto's Civic Fund[1]		
• Debentures of the City of Toronto and of Metropolitan Toronto	62%	38%
• Bonds and debentures of Canada, the provinces, other municipalities and fixed term deposits	38	26
• Stocks[2]		36
	100	100
City of Toronto's Fire Fund[1]		
• Debentures of the City of Toronto and of Metropolitan Toronto	59%	35%
• Bonds and debentures of Canada, the provinces, other municipalities and fixed term deposits	41	30
• Stocks[2]		35
	100	100
Metropolitan Toronto's Civic Fund[3]		
• Debentures of Metropolitan Toronto	87%	55%
• Bonds and debentures of Canada, the provinces and other municipalities	13	45
	100	100
Metropolitan Toronto's Police Fund[3]		
• Debentures of Metropolitan Toronto	82%	50%
• Bonds and debentures of Canada, the provinces and other municipalities	18	50
	100	100

Analysis of the Investment of Ontario's remaining individual municipal pension funds (continued)

Table No. 7-2

	1968	1972
City of Hamilton's Retirement Fund		
• Debentures of the City of Hamilton	19%	25%
• Bonds and debentures of Canada, the provinces and other municipalities	8	23
• Corporate bonds	34	19
• Mortgages	18	19
• Stocks[4]	20	13
• Purchase leasebacks	1	1
	100	100

	1968	1972
City of Ottawa's Superannuation Fund[5]		
• Debentures of the City of Ottawa and Ottawa Carleton	4%	4%
• Bonds and debentures of Canada, the provinces and other municipalities	69	57
• Corporate bonds	18	21
• Mortgages	9	9
• Fixed term deposits		9
	100	100

Notes:

[1]Toronto's pension funds have been investing in stocks since 1969

[2]At December 31, 1972, the cost of the Toronto stocks was $29,600,000, while their market was $35,550,000

[3]Metropolitan Toronto's Civic Fund has been authorized, recently, to invest in corporate bonds while its Police Fund has been authorized to invest in common stocks

[4]At December 31, 1972, the cost of the Hamilton stock was $4,038,000, while their market was $5,055,000

[5]Ottawa's superannuation fund has been authorized to invest in stocks since January 1, 1973

Investments of State and Local Government Retirement Funds in the United States

Table No. 8

	'66		'71	
	Amount	%	Amount	%
	in billions of dollars			
Obligations of:				
United States, states and local governments	$10	27%	$ 8	12%
Corporate and other bonds	19	51	36	56
Mortgages	5	13	7	11
Common and preferred stock	2	6	11	17
Other assets	1	3	3	4
	37	100	65	100

Source: United States Securities and Exchange Commission

Comparison of Returns
Non-Marketable Ontario Debentures Issued to OMERS
and Marketable Investments
for each of the years 1963 to 1972

Table No. 9

	'63	'64	'65	'66	'67	'68	'69	'70	'71	'72
Coupon rate[1]										
Non-marketable Ontario debentures	5.49	5.56	5.54	6.00	6.30	7.21	8.19	9.10	7.85	8.02
Yield to maturity[2]										
10 Provincial bonds[3]	5.43	5.53	5.59	6.29	6.70	7.60	8.40	9.04	8.03	8.13
10 Municipal debentures[3]	5.59	5.67	5.75	6.46	6.95	7.80	8.76	9.44	8.30	8.35
20 Corporate bonds[3]	5.42	5.51	5.67	6.45	7.02	7.85	8.69	9.23	8.41	8.33
Mortgages[4]	6.66	6.61	6.64	7.25	7.71	8.85	9.62	10.25	9.24	9.08
Ontario long bonds[3]	5.34	5.43	5.48	6.06	6.39	7.26	8.16	8.73	7.75	8.00
Rate of return[5]										
TSE's common stocks[6]	13.71	22.73	5.20	-8.93	13.62	20.26	2.39	-0.84	8.05	23.93

Notes:

[1]The weighted average yield to maturity of the debentures and bonds issued or guaranteed by the Province of Ontario, plus ⅛ of 1% (Canadian pay, only)

[2]Yield to maturity is calculated to include the annual income, plus a properly pro-rated portion of discount or premium

[3]Yearly averages, based on the McLeod, Young & Weir's published monthly indexes

[4]Yearly averages, based on the Bank of Canada's monthly indexes for conventional and NHA mortgages

[5]Rate of return is calculated to reflect market value at the beginning and end of a period, plus income received

[6]Toronto Stock Exchange's industrial index—taking quarterly values and dividends; dividends based on the 10-year monthly mean for the years 1963 to 1972—producing an average annual dividend of 3.37% for the period

Source of data and of calculations: McLeod, Young, Weir & Company, Limited

Comparison of Returns
Non-Marketable Ontario Debentures Issued to OMERS
and Marketable Investments
for the period 1963 to 1972

Table No. 10

	Average annual[1] yield to maturity	Average annual[2] yield to maturity based on the re-investment option	Rate of return[4] based on market values
Non-marketable Ontario debentures	6.71%	7.07%	N/A
10 Provincial bonds	6.85	7.22	4.63%
10 Municipal debentures	7.06	7.46	4.79
20 Corporate bonds	7.01	7.41	4.48
Mortgages	7.93	8.38[3]	N/A
TSE's common stocks	N/A	N/A	9.53

Notes:

[1] All bond and all mortgage interest payments are assumed to be payable half-yearly

[2] Based upon the assumption that the interest earned in one period is re-invested, in the next period, in the same class of security, at the rate appropriate for the period, e.g. bond interest earned in the second half of '63 is re-invested at the bond rate prevailing for the first half of '64

[3] If mortgage interest were to be compounded monthly, instead of half-yearly, an additional 14 basis points in yield, approximately, would be obtained. The return would be increased from 8.38% to 8.52%

[4] Rates of return (see note 5 on Table No. 9) are based on the appropriate McLeod, Young, Weir 40-bond index and the Toronto Stock Exchange's industrial index. Rate of return (calculated by the use of the "linked index method") is the 10th root of the quarterly percentage changes in the market values during the years 1963 to 1972.

Source of data and of calculations: McLeod, Young, Weir & Company, Limited

Hypothetical Increased Return
on the Investment of Funds in Marketable Securities
Rather than in Non-Marketable Ontario Debentures
(on the basis of Tables No. 9 and No. 10
and the Investment Weightings of this Table)
for the period 1963 to 1972

Table No. 11

	Investment Weighting	Return
Provincial bonds[1]	25%	1.81%
Municipal debentures[1]	10	.75
Corporate bonds[1]	15	1.11
Mortgages[1]	25	2.10
Common stocks[2]	25	2.38
Gross return	100	8.15
Deduct:		
Expenditures to manage the portfolio[3]		.15
Net return		8.00
Deduct:		
Gross return on the Non-marketable Ontario debentures		7.07
Hypothetical Increased Return		.93

Notes:

[1]Return based on the re-investment option, Table No. 10
[2]Return based on the values of the TSE's industrial index, Table No. 10
[3]In addition to OMERS' present administrative expenditures

Organization for Investment

Table No. 12

OMERS
Board of Management

Investment Policy Committee
- Finance Consultant
  to the Board of OMERS, chairman
- Director of Investments
- 3 senior persons from the investment management community
- Chairman of the OMERS Board, ex officio

Investment Strategy Committee
- Director of Investments, chairman
- Director of Economics
- Directors of each investment category

Investment Administration Committee
- Finance Consultant
  to the Board of OMERS, chairman
- Director of Finance of OMERS
- Several other officers

Director of Investments

Director of Economics

- Director of Bonds and Debentures
- Director of Mortgages
- Director of Stocks
- Director of Real Estate and Other Investments

- Accounts and Budgets
- Legal
- Audit
- Other Administrative Services

Source: James P. Marshall

Association of Municipal Clerks and Treasurers of Ontario

Table No. 13

An extract from a position paper of the Association's Advisory Committee of Municipal Treasurers

"The Committee, generally, felt that the present OMERS' investment policy was not appropriate and that there should be a general broadening of scope for the investment of OMERS' funds in accordance with prudent investment management. The Committee felt that the first matter to be resolved was that there should be an acceptance by all concerned that the primary objective of the fund was to ensure thai the best interests of its members was being served, rather than the interests of either the municipalities or the province. It was the general feeling that the members' interests were somewhat subservient to the provincial interests, at the present time, and because of this, the Committee opposed the present OMERS' investment policy.

The Committee felt that the primary objective in the management of OMERS' assets should be to maximize investment income, while maintaining the safety and the purchasing power of the assets. In pursuing the primary objective, specific investment policies should be followed that would incorporate the following:

(a) investment in accordance with the Regulations of The Pension Benefits Act (Ontario), as revised from time to time;

(b) selection of investment practices deemed, most likely, to result in the achievement of the primary objective;

(c) establishment of an organization designed to carry out, efficiently, the investment management of OMERS' assets;

(d) co-ordination of the efforts of those involved in pursuing the primary objective of the OMERS' Board; and

(e) the establishment of a system of reporting, including measurement of profitability, to enable the OMERS Board to determine the efficiency with which the primary objective is being pursued.

In order to maximize investment income, while maintaining safety and purchasing power, OMERS' investments should include a combination of fixed income securities (mainly, bonds and mortgages) and growth securities (mainly, common stocks) in appropriate proportions—with the proportion of bonds to mortgages in the fixed income securities to be flexible to permit the highest yielding fixed income securities available to be purchased at any given time whether bonds or mortgages."